European ABS: 2020 review and 2021 outlook

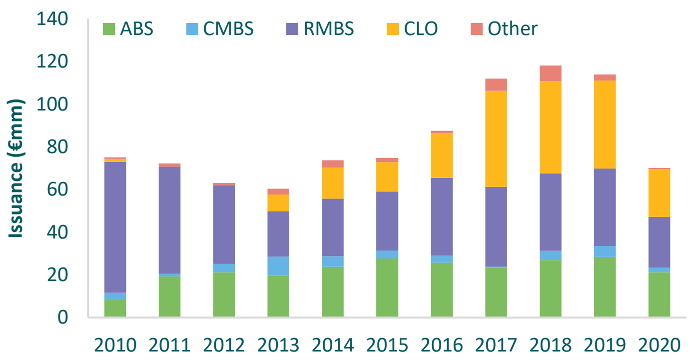
January 2021

- **2020 demonstrated the resilience of European asset-backed securities (ABS) and highlighted the strong relative value offered by the market. This paper discusses what happened during a historic year of significant macro volatility driven by the COVID-19 pandemic, our thoughts on why and where relative value still exists in ABS, and our outlook for 2021.**
- **The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Where past performance is shown, this is not a guide to future performance.**

European ABS withstand a turbulent 2020

As with most areas of financial markets, COVID-19 had a material effect on European ABS in 2020. Issuance had steadily increased in previous years, with volumes exceeding €100bn in 2018 and finishing just below that level last year (see Figure 1). The global impact of COVID-19 in March significantly affected primary issuance during the second quarter (Q2), and while European ABS saw unseasonably high summer 'catch-up' issuance and a busy end to the year, we expect 2020 volumes to total around €65bn, comfortably short of our previous expectations.

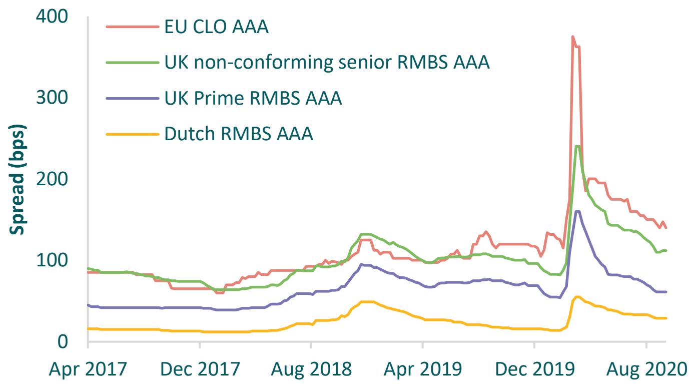
Figure 1. European ABS total issuance declines in 2020



Source: J.P. Morgan International ABS & CB Research, 4 Dec 2020

At the start of 2020, ABS spreads had tightened, with a good volume and variety of new issuance allowing investors to put cash to work across asset classes. The relative value of ABS versus other fixed income securities led to healthy tranche oversubscription in key areas. Following the COVID-19 outbreak in Europe, risk assets saw a fast and dramatic repricing. At the same time, many defensive fixed income assets, including senior European ABS, also sold off. The speed and severity of the spread widening in even the most highly rated and short-dated profiles in European ABS (see Figure 2) led us to conclude that March and April's market prices had, in many cases, decoupled from the fundamental credit resilience of these instruments to an extent not seen since the immediate aftermath of the Lehman Brothers default in 2008.

Figure 2. European ABS sell-off in March and April

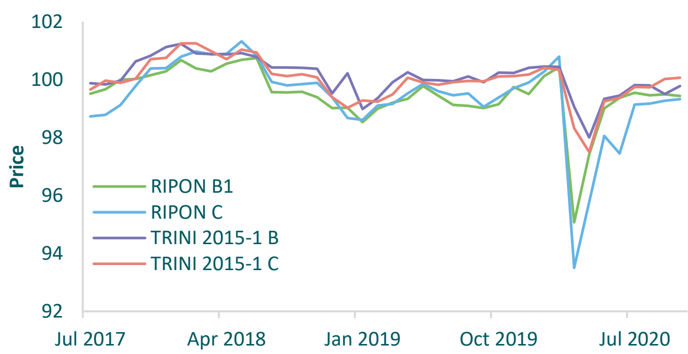


Source: M&G, J.P. Morgan, 8 October 2020

We re-underwrote all of our holdings and concluded we were comfortable with the stress resilience of the vast majority of our most junior positions. As a result, we concluded that the spreads available for high-quality assets represented a buying opportunity for the medium-term-focused investor, and we set about selectively raising capital from both new and existing investors.

Market sentiment improved towards the end of Q2, with optimism driven by unprecedented quantitative easing from central banks and declining COVID-19 infection rates in many countries. The accompanying rise in global risk appetite saw a noticeable recovery in European ABS prices during Q2, as shown in Figure 3.

Figure 3. European ABS recovery in Q2 2020



Source: *M&G, 1 October 2020*

Meanwhile, the first post-COVID new issue transactions were priced, primarily across UK consumer transactions and European CLOs, and often on a bilateral or small-club basis. We participated in a number of these trades during the quarter, attracted by more conservative structures, cleaner collateral and better pricing than prior to COVID-19. We also obtained better allocations, given the reluctance or inability of competitors to consider primary market opportunities. We detail some high-level information on a selection of these purchases below.

ELVET 2020-1 C (RMBS)

Overview: Single-A rated mezzanine tranche in a UK prime RMBS transaction issued by Atom Bank, where M&G purchased the entire issued capital structure following bilateral negotiations with the originator. The class C tranche pays a coupon of SONIA plus 225 basis points ('S+225'), which will increase to S+325 if the transaction is not called at its first optional redemption date in June 2025. **Key characteristics:** The portfolio consists of owner-occupied collateral with a weighted-average current loan-to-value (LTV) of 67.9%, zero delinquencies and only 5.4% exposure to self-employed borrowers. **Comments:** We expect that the re-introduction of the Bank of England's Term Funding Scheme will lower the amount of UK prime RMBS issuance in coming years, so being able to access a high-quality pool on a bilateral basis was very appealing.

ELSTR 1 A (RMBS)

Overview: AAA rated senior UK RMBS tranche in a new issue transaction from Enra Specialist Finance, which comprises prime buy-to-let mortgages, as well as prime and near-prime first- and second-lien owner-occupied mortgage collateral. The senior bonds pays a S+140 coupon, which increases to S+280 if the transaction is not called in November 2023. This is one of the highest step-up coupons of any currently outstanding UK RMBS senior bond. **Key characteristics:** The class A bond has 25.25% credit enhancement and is backed by 66.65% weighted-average-indexed LTV collateral, with an average current balance of c.£82,500. The transaction has only 2.9% exposure to COVID-19 payment holiday borrowers, which is well below the sector average. **Comments:** We were one of a small number of investors that were pre-sounded on this trade. Following negotiations on structure and pricing, we were able to secure a significant, protected order in the class A tranche.

SGSHR 1X A (social housing CMBS)

Key characteristics: A portfolio of 1,609 residential units located across England provided for social housing at regulated level of no more than 80% of the local market rate. The senior bonds in this capital structure were priced with a S+125 coupon. **Comments:** In terms of ESG considerations, Sage is a for-profit registered social housing provider regulated in the same way as not-for-profit housing associations. Transactions are issued under Sage's social bond framework, which has been independently verified by Sustainalytics. We were one of a select number of investors that were pre-sounded on this transaction and we participated in the investment grade tranches for a number of portfolios.

Relative value in ABS

Once the new issue market for European ABS re-opened, we observed a clear distinction in the credit protection offered by primary CLOs, such as BBAME 1X (shown in Figure 4), compared to transactions issued prior to March, such as AVOCA 21X (shown in Figure 5). We were able to buy BBB rated new paper, which structurally appears comparable to single-A tranches from Q1 2020, but at materially wider spreads. Given new transactions typically have a greater ability to withstand extreme default stresses than pre-COVID-19 issues, we were also able to de-risk our portfolios by selling existing BBBs in the secondary market to buy more robust new issue profiles.

Figures 4&5. Post-COVID BBBs offer comparable protection to pre-COVID single-As, but with materially wider spreads

4. BBAME 1X capital structure, priced in June 2020. Source: M&G proprietary monitoring tool

Category	Tranches	Current balance (€m)	Spread	Mdys/SP/Fitch	Par attach	Par detach	Market value attach	Market value detach	Breakeven price
AAA	A	140.0	E+1.6	NA/AAA/AAA	44.3%	100.0%	43.5%	43.5%	99.20
AA	B1, B2	27.5	2.65, E+2.2	NA/AA/AA	33.3%	44.3%	32.4%	43.5%	98.80
A	C	20.0	E+2.8	NA/A/A	25.4%	33.3%	24.4%	32.4%	98.63
BBB	D	15.0	E+4.1	NA/BBB/BBB-	19.4%	25.4%	18.3%	24.4%	98.38
BB	E	11.0	E+6.84	NA/BB/BB-	15.0%	19.4%	13.9%	18.3%	97.86
B	F	5.5	E+7.2	NA/B-/B-	12.8%	15.0%	11.7%	13.9%	97.84
Equity	Subordinated	31.5	0		0.3%	12.8%	-1.0%	11.7%	

5. AVOCA 21X capital structure, priced in February 2020. Source: M&G proprietary monitoring tool

Category	Tranches	Current balance (€m)	Spread	Mdys/SP/Fitch	Par attach	Par detach	Market value attach	Market value detach	Breakeven price
AAA	A1, A2	279.0	E+0.89	NA/AAA/AAA	38.0%	100.0%	37.1%	37.1%	99.04
AA	B1, B2	45.0	1.85, E+1.5	NA/AA/AA	28.0%	38.0%	27.0%	37.1%	98.59
A	C	32.5	E+2.1	NA/A/A	20.8%	28.0%	19.6%	27.0%	98.36
BBB	D	28.0	E+3.15	NA/BBB/BBB-	14.6%	20.8%	13.3%	19.6%	97.58
BB	E	23.8	E+5.1	NA/BB-/BB-	9.3%	14.6%	8.0%	13.3%	95.25
B	F	12.5	E+7.48	NA/B-/B-	6.5%	9.3%	5.2%	8.0%	94.35
Equity	Subordinated	35.6	0		-1.4%	6.5%	-2.9%	5.2%	

ESG

We are long-term investors and we believe ESG plays a significant role in the success of our investments. As such, ESG analysis is an integral part of our investment process. We incorporate ESG issues into our analysis wherever we feel they are likely to have a meaningful impact on risk or return. Over recent years, this has been incorporated in every credit write-up completed for each new investment made.

There are growing signs that regulators are pushing ABS markets to incorporate ESG-style reporting and considerations. The lack of independent, third-party ESG scores for ABS makes it difficult to include explicit ESG targets in investment objectives; however, managers should be expected to incorporate an ESG framework in investment decisions. In Figure 6, we illustrate how we incorporate ESG considerations into ABS investing. We will also be providing you with further updates on our ESG efforts in early 2021, which you should receive from your usual M&G contact.

Figure 6. Our ESG considerations

	ENVIRONMENTAL		SOCIAL		GOVERNANCE	
	EXCLUDE	ASSESS	EXCLUDE	ASSESS	EXCLUDE	ASSESS
All ABS	*No exclusions*	• Tighter pricing accepted for long-term, sustainable collateral • % of green receivables	*See individual criteria below*	• How socially responsible is the underlying lending operation • Underwriting and recovery practices	• Sponsor related, e.g. money laundering considerations, criminality, evidence of poor business practises	• View on management/ sponsor/swap counterparty • Fines/regulatory issues at sponsor • Data reporting/ openness
RMBS		• Energy efficiency (e.g. renovations) • High environmental risk regions	• Predatory lending • Unsuitable and unaffordable borrowing	• Mortgage affordability, % low income borrowers • Owner-occupied or buy-to-let	• High 'churn' lender • Predatory servicing practises (work-out process)	• High pricing/liquidity premium for new entrants / untested lending practises
Auto loan ABS		• % of diesel cars in the pool	• As per RMBS	• Financial education provided for more complex financing options?	• As per RMBS	
Consumer loan ABS			• Payday lending	• As per auto loans		
CMBS		• Energy efficiency • High environmental risk regions e.g. % of assets in flood risk areas	*No exclusions*	• Social housing CMBS: for- or not-for-profit?	• Erosion of lending norms affecting the sustainability of the market, e.g. too loose or non-existent covenants	
CLO		• Specific concerns about oil & gas		• Effort to rate large corps on social metrics e.g. specific concerns on finance companies, tobacco	• CLO manager governance e.g. unsatisfactory risk retention	• Misalignment of interest with CLO manager
SRT – corporate		• Effort to rate underlying borrowers on environmental metrics, either line by line or by sector e.g. oil & gas exposure		• As per CLOs	• Usage of capital released. Every SRT issuer we deal with is a routine lender to the economy it is involved in. We only invest in core assets in core jurisdictions	• Issuer jump to default risk e.g. controversies leading to high default risk
SRT – other		• Refinance risk		• Social positive impact e.g. SME lending to the real economy	• As per SRT corporates	

Brexit

The Brexit deal agreed between the UK and EU at the end of 2020 provides greater certainty around their future trading relationship, which we believe should mitigate the potential risks that failure to reach a mutual agreement would likely have posed for sterling-denominated assets. The deal could be potentially supportive for UK ABS spreads in 2021, given the sizeable risk premium attributed to these assets in recent years. On the supply side, the agreement is likely to give UK ABS originators more confidence to issue transactions in Q1 2021, which may have been considerably less likely in a no-deal scenario.

Outlook

2020 saw almost unprecedented levels of volatility across financial markets. Navigating these conditions required significant levels of resilience and adaptability, including, from our perspective, the successful implementation of working from home within the ABS team and wider M&G organisation.

The broad recovery across asset classes has been remarkable, aided by swift and significant policy responses from governments and central banks. While the recovery in European ABS has been more gradual than that in corporate and sovereign bond markets, we believe this disparity can be explained primarily by the lack of direct benefit from central bank asset purchases in ABS relative to other areas.

In March, we felt the significant re-pricing across ABS markets presented attractive medium-term opportunities for investors with patient capital and the extensive resources required to evaluate each individual trade. This view appears to have been justified to date, with the combination of price recoveries and more robust structures from Q2 onwards enabling us to participate in potentially attractive deals and to reposition our portfolios.

Nevertheless, unlike other areas of European fixed income, European ABS spreads are still generally wider than at the start of 2020. We believe the relative value argument for this asset class therefore remains compelling. In our view, ABS markets retain significant potential for both future opportunities and further yield compression in 2021, which we feel, should they materialise, we are well-positioned to capture.

M&G ABS team

Key terms

- ABS: asset-backed securities
- CLO: collateralised loan obligation
- CMBS: commercial mortgage-backed securities
- Market value attach: minimum of pool-level losses at their given market value at which a given tranche begins to suffer losses
- Market value detach: market value amount of pool losses that wipe out the tranche
- Par attach: minimum of par pool-level losses at which a given tranche begins to suffer losses
- Par detach: amount of par pool losses that wipe out the tranche
- RMBS: residential mortgage-backed securities
- SONIA: sterling overnight index average
- SRT: significant risk transfers
- STS: simple, transparent and standardised